409 Mandates for Employee Severance Agreements Teleconference

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409A and Deferred Compensation Overview

INTRODUCTION

- Final IRS regulations will go into effect on January 1, 2009. Companies should ensure they are compliant by year-end, December 31, 2008
- Section 409A applies to taxable compensation that is or may be payable in future years to employees, independent contractors and directors
  - Explanation for amounts “earned and vested” as of December 31, 2004
- Section 409 places substantial limits on the timing of deferral elections and the form/time of deferred compensation payments

INTRODUCTION

- Section 409A covers:
  - employment agreements
    - gross ups
    - indemnifications
  - severance arrangements
  - SERPs
  - stock options
  - SARs
  - equity incentives
- Section 409A requires all covered arrangements to comply in writing by December 31, 2008

Introduction (cont'd)

- Section 409A failures result in:

  - immediate inclusion in income of all vested compensation/benefits
  - additional 20% penalty tax
  - interest at the underpayment rate plus 1%

Section 409A Requirements

- Section 409A establishes timing requirements for deferral elections:

  - initial elections
  - subsequent elections

Section 409A Requirements (cont'd)

- Section 409A restricts distribution to a preset schedule or limited list of permissible events:

  - separation from service
  - death
  - disability
  - change of control
  - specified date or schedule
  - unforeseeable emergency

Section 409A Requirements (cont'd)

- Section 409A requires that payment conditions satisfying Section 409A requirements (including six month delay for specified employees in public company) must be documented
- Specify election provisions, if elections permitted

Section 409A Requirements (cont'd)

- Incorporation by reference:

  - separation from service
  - disability
  - change in control
  - specified employee

- Savings clauses

When is severance treated as deferred compensation subject to 409A?

1) Good Reason

1) Safe Harbor

2) Short-Term Deferral Exception

4) Separation Pay Plan Exception

EMPLOYMENT AGREEMENTS: SEVERANCE

- Assume that employee gets 3 times pay in a lump sum if terminated not for cause by the employer
- The right to the severance is treated as being subject to a substantial risk of forfeiture. Therefore, if paid on or before March 15 of the year following termination, the severance is exempt from Section 409A under the short-term deferral rule

Employment Agreements: Severance (cont'd)

- Assume that employee gets severance over 36 months
  - the amount is subject to Section 409A because the payments extend beyond March 15.

Employment Agreements: Severance (cont'd)

- However, if the payments are designated as separate payments, payments prior to March 15 are exempt under short-term deferral rule

- The importance of being exempt under short-term deferral rule is to avoid six-month delay for specified employees of public company

Employment Agreements: Severance (cont'd)

- Payments upon involuntary separation from service are excluded to the extent the payments are made no later than the end of second year following the year of separation and do not exceed 2 times the lesser of (i) the employee's annual compensation; and (ii) the Code Section 401(a)(17) limit

Employment Agreements: Severance (cont'd)

- Assume that severance is payable upon a resignation by employee for "good reason"
- Good reason may in some circumstances be treated as an involuntary termination for purposes of the short-term deferral and separation pay exclusion

Employment Agreements: Severance (cont'd)

- Good reason termination treated as involuntary termination if good reason is defined to require actions by the employer resulting in a material negative change to the employee's employment relationship (e.g., diminution in duties, conditions under which the duties are performed, or compensation received)

Employment Agreements: Severance (cont'd)

- Additional factors considered (i) was the termination result of bona fide good reason condition rather than to avoid Section 409A, (ii) whether payments same as if involuntary termination, and (iii) was notice and opportunity to cure required

Employment Agreements: Severance (cont'd)

- Safe harbor good reason termination if:

  - good reason termination occurs within 2 years of the following:

    -- material diminution in base compensation
    -- material diminution in employee's authority, duties or responsibilities

Employment Agreements: Severance (cont'd)

-- material diminution in authority, duties or responsibilities of the person to whom the employee reports
-- material diminution in the employee's budget
-- material change in geographic location
-- any other action or inaction that constitutes a material breach by the employer of the employment agreement

Employment Agreements: Severance (cont'd)

- Compensation payable is substantially identical to amount, time and form of payments due on the involuntary termination
- Employee must provide notice within 90 days, and the employer must have a 30-day cure period

EMPLOYMENT AGREEMENTS: REIMBURSEMENTS

- Assume employee gets continued medical coverage and automobile reimbursement for 36 months after any termination
- Payments comply with Section 409A if payments are paid at a specified time or pursuant to a fixed schedule

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Employment Agreements: Reimbursements (cont'd)

- Reimbursements (including tax gross-ups) will generally satisfy this rule and thus comply with Section 409A if reimbursement is for eligible expenses during an objectively prescribed period and reimbursement made no later than end of following year

- Similar rules apply for in-kind benefits

Employment Agreements: Reimbursements (cont'd)

- Additional reimbursement examples:

  - business expenses while working
  - attorneys fees to enforce contract
  - post-termination cooperation clause and reimbursement for reasonable expenses incurred

Strategies for Compliance

1.) Generally

2.) Pilot voluntary correction program